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Re: IASB’s Exposure Draft ED/2010/9 Leases  
FASB’s Proposed Accounting Standards Update Leases (File Reference No. 1850-100)  

Dear Sir/Madam,  

The World Bank appreciates the opportunity to provide comments on the exposure drafts on leases. Overall, we support the Boards’ efforts to enhance financial reporting related to leases providing guidance to both lessees and lessors and creating increased convergence between IFRSs and US GAAP. This proposal will result in the recognition of significant volumes of lease assets and commitments that are currently off balance sheet which, we believe, will improve comparability and transparency of financial statements. In our view it is essential that the final standard makes a clear distinction between in-substance purchases and leases. We believe the proposal achieves that reasonably well for lessees but not lessors.  

We support the proposed right-of-use approach to lessees’ accounting. We disagree, however, with certain detailed provisions related to it. For example, we do not fully support the treatment of extension options and certain contingent rentals, even though we agree that some probability assessments are needed in order to prevent structuring opportunities. We are concerned that the proposed approach will result in recognizing “intention based” obligations for which the obligating event has not yet occurred. We believe this contradicts the conceptual framework and the general definition of a liability, and could distort debt-based ratios.
While we support the Boards’ effort to simultaneously change the lessee and lessor accounting models, we do not support the proposed approach for lessors. We believe the “dual” approach introduces unnecessary complexity to lessor accounting and creates similar application issues as the existing accounting model for lessees. The dual approach is also asymmetric with the proposed lessee accounting.

The performance obligation model seems theoretically more sound and better aligned with the proposed lessee accounting than the derecognition approach and we believe that with certain enhancements it could serve as the single lessor accounting model. The derecognition model allows a lessor to partially derecognize the underlying asset that is not in the lessee’s balance sheet either. It also allows upfront revenue recognition of profit margins whereas the lessee will be recognizing the corresponding expenses later. We question the need for this asymmetry and reiterate that the final standard should clearly distinguish in-substance purchases from leases, so that the former will be accounted for as purchases under other applicable accounting standards and the latter as lease arrangements under this proposed standard.

We strongly encourage the Boards to reconsider the lessor accounting model. If it is necessary to delay the issuance of the lessor model in order to achieve a more simplified model that is better aligned with the lessee accounting, we would prefer delaying the entire lease standard over issuing lessee and lessor standards separately.

We expect that the proposed approach will significantly increase the workload related to the financial reporting of lease agreements, especially during the transition period. Reporting entities will need transitional provisions to ensure they have sufficient time to set up systems and required processes for all existing and future leasing contracts.

The rest of our comments are included as responses to specific questions in the attached Annex. Thank you for the opportunity to provide our views.

Sincerely,

[Signature]

Charles A. McDonough
Vice President and Controller
Annex - Responses to Selected Questions Posed

Question 1: Lessees
(a) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?
(b) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

We agree with these proposals. In our view the recognition of a right-to-use asset and a liability to make lease payments, and the related amortization of the asset and interest on the liability, will more faithfully represent the economic substance of leasing transactions than is currently the case under existing standards on lease accounting.

Question 2: Lessors
(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?
(b) Do you agree with the boards’ proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?
(c) Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided for under US GAAP (paragraph BC15)? If not, why not? What approach should be applied to those leases and why?

(a) – (b) We do not support the dual approach for lessors. It seems overly complex and we believe that in practice its application would involve issues very similar to those experienced in the current lessee accounting, including arbitrary tests resulting in different treatment of identical or nearly identical transactions.

As stated in the main body of our letter, we find the performance obligation model to be theoretically more sound than the derecognition model and support it as the single lessor model for its better alignment with the proposed lessee model. We see no grounds for allowing the lessors to do the partial sales accounting with accelerated revenue recognition whereas the lessee would be accounting for the same contract as a lease. If the lessor has truly transferred risks and rewards associated with the asset, it should be able to either automatically transfer the ownership of the asset in the end of the lease; or if the lessee does not wish to own the asset in the end of the lease, for one reason or another, to include a clear bargain purchase option in the lease. In both cases sales accounting would be achieved under this proposal, and rightfully so we believe. We also believe that if the proposed accounting model for lessees became final, there would no longer be strong incentives for writing lease agreements that transfer nearly all risks and rewards to the lessee, as from the lessee’s perspective off-balance sheet accounting of leases would no
longer be possible. Instead, we would expect to see an increased amount of purchase agreements that include financing elements.

(c) We do not believe a different approach is needed for leveraged leases.

**Question 3: Short-term leases**

This exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is 12 months or less:

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognize lease payments in the income statement over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other topics and would recognize lease payments in the income statement over the lease term (paragraph 65).

(See also paragraphs BC41–BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

(a) We agree with the proposed approach for lessees.

(b) We do not agree with the proposed approach for lessors and find it inconsistent with the proposed requirements for lessees. All assets and liabilities arising from lease contracts should be recorded by both lessees and lessors and we propose a simplified model, similar to that proposed for lessees, be included in the final standard for lessors.

**Question 4**

(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

(c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

(a) We agree with the definition of a lease.
(b) For the most parts, we agree with the criteria and believe it to be necessary to keep the criteria very limited, merely distinguishing pure right-of-use contracts from those transferring ownership. One could argue that when the non-cancelable lease term equals the economic life of the leased asset, the in-substance purchase criteria should be met, too. However, there is a clear difference between contracts that transfer ownership and those that do not and we believe that only contracts transferring ownership should be treated as in-substance purchases. If that is also the Boards’ intention, it may be useful to include application guidance that more clearly states this.

As discussed above in our response to Question 2, if, in a particular contract, it is deemed important to achieve sales/purchase accounting and all risks and benefits are said to be transferred, it seems reasonable to assume that the lessor and lessee can agree to automatically transferring the ownership in the end of the lease or including a clear bargain purchase option in the lease agreement.

Finally, if the Boards decide to keep the derecognition approach for lessors, we believe that more guidance is needed regarding interaction of “all but trivial amount of the risks and benefits” and “significant risks or benefits” and the distinction between in-substance purchases and the derecognition approach.

(c) We find this guidance sufficient.

**Question 5: Scope exclusions**

This exposure draft proposes that a lessee or a lessor should apply the proposed guidance to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative scope would you propose and why?

We agree with the other proposals.

**Question 6: Contracts that contain service components and lease components**

This exposure draft proposes that lessees and lessors should apply the guidance in proposed Accounting Standards Update, Revenue Recognition (Topic 605): Revenue from Contracts with Customers, to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

(a) The FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

(b) The IASB proposes that:
(i) A lessee should apply the lease accounting requirements to the combined contract.  
(ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
(iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the guidance in the exposure draft on revenue from contracts with customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

We agree with the proposed guidance for distinct service components. However, we also believe that all significant service components should be separately accounted for by both lessees and lessors, whether distinct or non-distinct.

While we understand and support the IASB's intention to prevent premature revenue recognition with paragraph 6(c), we believe that a better solution would be to ensure that all significant service components are separately accounted for. In general, we do not support creating asymmetric accounting models for lessees and lessors.

Finally, we would like to note that if the performance obligation model was chosen as the sole accounting model for lessors the issue of premature revenue recognition would be moot. Also, the Boards should ensure they agree on a common approach before issuing the final standard.

**Question 7: Purchase options**

This exposure draft proposes that a lease contract should be considered terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

We support the proposals.

**Question 8: Lease term**

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

We do not support the proposal that will result in recognizing "intention based" obligations for which the obligating event has not yet occurred. We believe this contradicts the conceptual framework and the definition of a liability, and could distort debt-based ratios.
We would prefer only including the non-cancellable lease term and those extension options that are reasonably certain to be exercised. If the holder has no realistic alternative to exercising the option, it would be considered reasonably certain to be exercised. E.g. the lessee’s business is highly dependent on a specific asset and the cost of modifying the asset is so significant that letting the option expire and switching to another asset is not an economically feasible alternative.

**Question 9: Lease payments**

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be reliably measured? Why or why not?

We agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease, but only if the contingencies are of such nature that the lessee cannot control them. This would mean e.g. excluding rentals tied to the usage of the leased asset, unless the usage is reasonably certain to occur as the lessee does not have economically feasible alternatives to using the asset. Similar to our comments related to extension options, we believe this additional provision is necessary to better align the lease accounting with the conceptual framework and the general definition of a liability.

For contingencies outside the lessee’s control we agree with using an expected outcome technique which will yield more meaningful results than the most likely outcome technique.

Finally, we agree that contingent rentals and expected payments under term option penalties and residual value guarantees should be included in the measurement of the lessor’s right to receive lease payment only if they can be measured reliably.

**Question 10: Reassessment**

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?
We agree with the proposal.

**Question 11**
Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

We agree with the proposal.

**Question 12: Statement of financial position**

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

(c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

(a) We agree with this proposal.

(b) We do not agree with the net lease asset or liability presentation approach as we believe it to be inconsistent with the conceptual framework and general offsetting provisions. Instead, we would require full gross presentation approach with assets and liabilities being classified on different sides of the balance sheet. This approach would result in more transparent presentation and we believe the benefits of doing so would outweigh issues related to increasing the total assets and total liabilities in the lessors’ balance sheets.

(c) While we would prefer choosing the performance obligation approach over the derecognition approach, should the latter be retained in the standard, we would agree with this proposal.
(d) We believe this information could be included in the notes instead.

**Question 13: Income statement**

*Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in the income statement (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?*

We believe the required presentation should depend on the reporting entity’s business model. If leasing transactions are significant to the reporting entity’s business model, separate presentation on the face of the income statement would be appropriate. In other cases such information could be presented in the notes.

**Question 14: Statement of cash flows**

*Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?*

Similar to our response to Question 13 above, we believe the required presentation should depend on the reporting entity’s business model.

**Question 15**

*Do you agree that lessees and lessors should disclose quantitative and qualitative information that:
(a) identifies and explains the amounts recognized in the financial statements arising from leases; and
(b) describes how leases may affect the amount, timing and uncertainty of the entity’s future cash flows? (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?*

We agree with the proposal.

**Question 16**

(a) This exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?
(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?
(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?
(a) We agree with the proposed approach.

(b) We believe full retrospective application should be permitted as long as it is consistently applied to all leases. Full retrospective application would provide theoretically more correct data and therefore should be permitted.

(c) We are not aware of any.

**Question 17**

*Paragraphs BC200–BC205 set out the boards’ assessment of the costs and benefits of the proposed requirements. Do you agree with the boards’ assessment that the benefits of the proposals would outweigh the costs? Why or why not?*

We agree with the Board’s assessment for lessee accounting. However, we believe the proposed lessor approach is too complex and the cost of implementation is likely to exceed expected benefits. We would suggest that more research and field work be conducted before finalizing the lessor accounting model.

**Question 18**

*Do you have any other comments on the proposals?*

We believe specific guidance is needed related to accounting for lease incentives, leasehold improvements, as well as accounting for the time period between the date of inception and date of commencement (which could be significant in certain cases).

**Question 19**

*Should any of the proposed guidance be different for non-public entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?*

We believe such scope-outs do not belong in global accounting standards but it would be up to individual jurisdictions to allow them separately, e.g. for private companies and not-for-profit organizations under certain size thresholds, as deemed appropriate by each individual jurisdiction.